DOW THEORY LETTERS INC.

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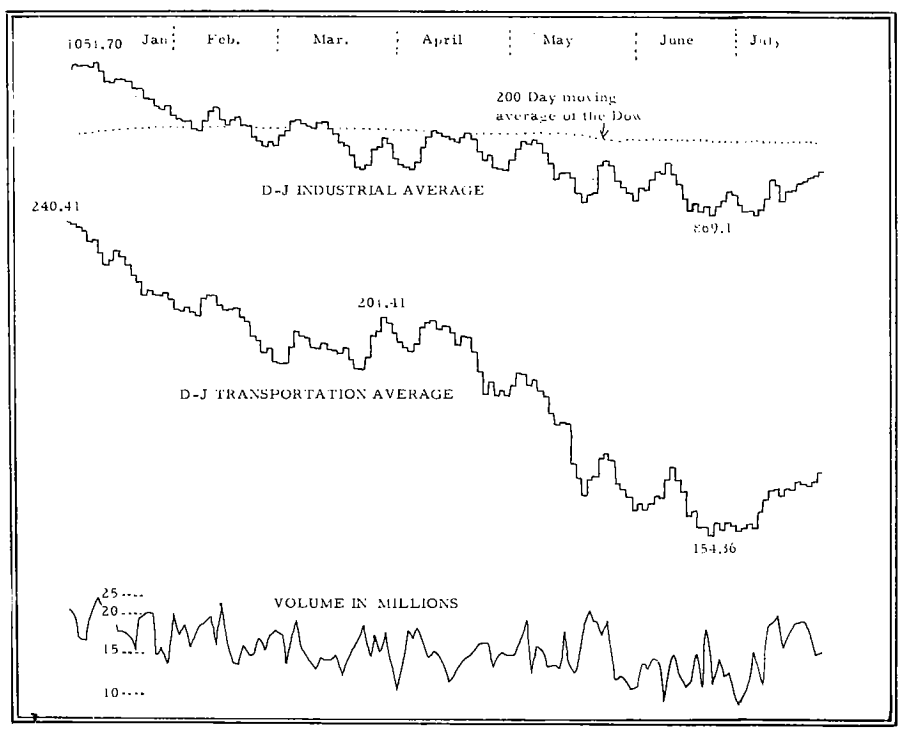
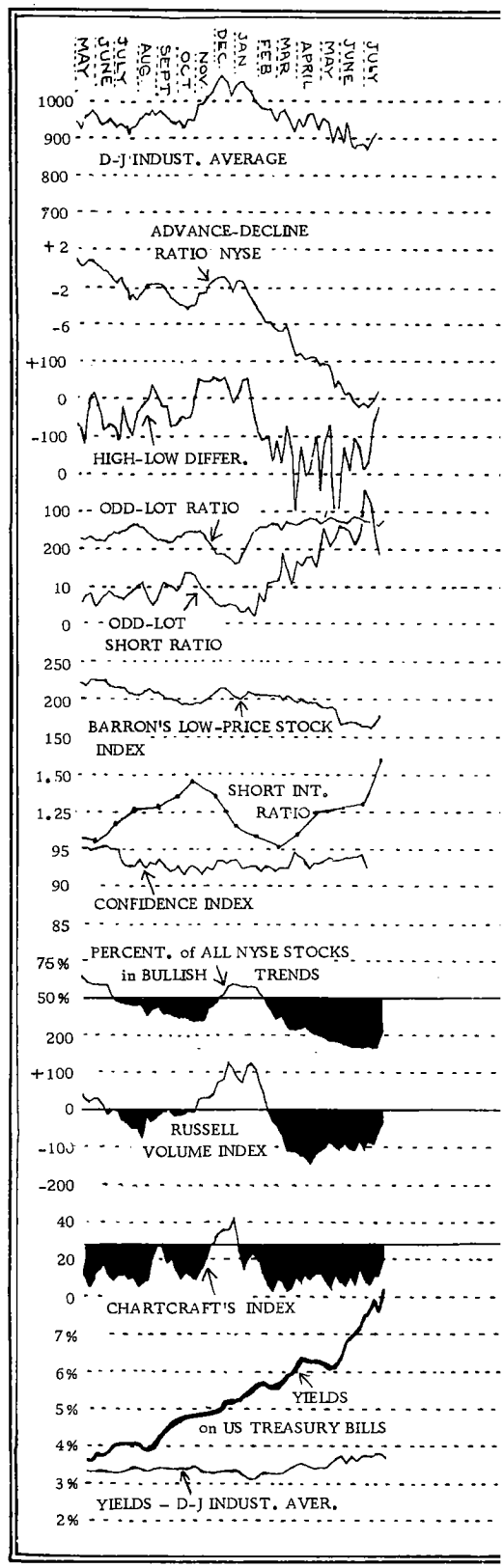
PUZZLES: Did you ever wonder why, with 30 million stockholders in the US, there are (only) a few dozen market advisories who are quoted and actually taken seriously (even within the advisory profession)? I think the answer is that there aren't too many people who have the following qualities (1) a willingness to be totally obsessed with Wall Street, (2) the stamina to read and study for probably half to two-thirds of their waking day, (3) the gall (courage?nerve?) to think that they can actually help others in the market, (4) the ability to get their thoughts down on paper in a manner clear enough and interesting enough so that others will pay money to read them.

That's just part of it. Then there's the agony of trying to be right. I must admit that perhaps half the time the Wall Street coast is clear, the trend of the market and the economy seems "obvious," and everything goes about as expected. But at least 50% of the time the picture is one of paradoxes, murkiness, confusion and pieces that don't fit.

Yet the puzzling times are the most dramatic ones, and they are the ones I like best. Take the present, for instance (to which you'll likely answer, "No, Russell, why don't you take it?"). Today I read reports from some of the nation's most brilliant analysts, Zweig, Schaeffer, Granville, Janeway, Dines, Heiby, Holt, and you know what — they don't all agree. Then there's that icy-cold realization that as always, I'm on my own.

I'm writing this report in two broad "sections." The first deals with the technical situation, and there is no denying the fact that the technical underpinnings of this market are now looking better than they have at any time this year. The great bulk of the market has been smashed to its knees, compressed like a rubber ball which is now ready to "bounce back." I'd say that the odds on a secondary (but important) bottom having been seen during late-June - early-July are at least 50/50. At worst, I see one final cleanout sweep which would topple the big, high-priced Dow stocks, but as I say, I give this possibility only a 50/50 chance.





In other words, the market is trying to "get it together" for a real upward swing, and the chances are fairly good that it is going to do it. So much for the happy news.

The second "section" of this Letter really deals with the long-term fundamentals, and here I don't like the scene. On the big picture, nothing (economically speaking) since the bull market peak of 1966 has been corrected. The fundamental background is, in fact, far worse now than in '66. My overseas buddy, Harry Schultz, has just written a brilliant letter, and he states that the inflation-logged US is heading not for a European type of dictatorship but for "Latinism" with stop-go inflation varying between 20% and 35% (!) and an ultimate slump into impotency. The dollar, says Harry, will "slowly withdraw from the world as an international currency." Personally, I see an interest rate crisis, a bond slump, more US incompetency, and the usual "actions" of the politicians which means — moving only when their backs are to the wall and then doing only enough to quiet the worst screams of the loudest critics. In a nutshell, the economic background is sick, weak, inflationary, while the political background is chaotic.

THE MARKET: In Letter 568 (July 6) I noted that "The market has been in a state of collapse during all of 1973, but every point down is a point nearer the bottom (and the Averages are not going to zero this year)," ...."Will-Go calls for some upside (remember that word) action around the first week in July."

In Letter 569 (July 18) I wrote that the Dow has closed down on an end-of-the-month basis for six months in a row, January to June, 1973. This had happened only once before, during the 1941-42 collapse amid World War II. I also noted that "the downside momentum of this market seems to be ebbing" and then discussed a number of technical factors, concluding that "Those are all marks to watch, and if they hold we should shortly get some mileage on the upside."

Since Letter 569 many interesting technical developments have come to pass. For instance, turning to the page 1 composite chart, we see that both the Dow Industrials and the A-D ratio have broken their downtrend and have been moving higher. The high-low differential (see last Letter, page 6) has formed a base and broken out on the upside. Odd-Lot shorts formed their typical spike (height of bearishness) and are now receding. The short interest ratio has risen to 1.65. The percentage of all stocks bullish has climbed to 29%, from its low of 16%. The Russell Volume Index is still negative but trending higher. The Chartcraft index rose to 24, still negative (or under 50%) but at a high for 1973. Not shown here but very important (see Letter 567, page 3) is the most-active stock index. This index turned plus on July 18 (for only the second time in 1973), and it has now remained plus for 6 consecutive days, a feat which has not been seen since 1972.

The one very dark spot is the interest rate picture (much more on this later) as seen in the soaring T-Bill rates and the declining yield on the Dow. But all in all, the technical indications strongly suggest that we could be in for our first real climb of 1973, an upside move which, if nothing else, will serve to correct one of the worst beatings the stock market has taken in its history.

At this point the Industrial and Transport Averages have mounted a series of little upward zig-zags, and the action following the next decline will be of utmost significance. The A-D ratio has rallied to its June peak, and here too the situation is growing dramatic. Finally, the Primary Trend Indicator (PTI) on July 23, advanced exactly to its preceding early-July peak. By the next report we should have either an "all clear" or a "troubled" reading regarding the secondary or intermediate trend.

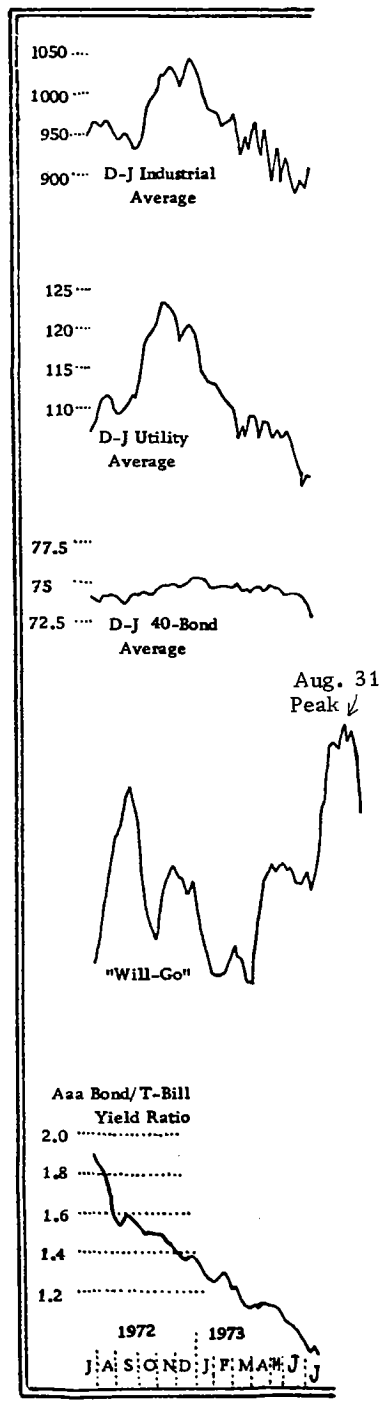
Many subscribers are probably wondering "How the market can rise in the face of the money crunch, the searing inflation, an absence of Government (we even seem to be out of incompetents) in Washington, and a new set of complicated controls? But I will remind subscribers that when a ball is tossed to the ground it bounces and generally the harder it is thrown the higher it bounces.

CONCLUSION: The technical situation looks promising for a good intermediate rise. The picture would, in fact, look almost clear except for one thing — interest rates and monetary problems. Thus we have an exotic split in the 1973 picture, with the market at this point looking strong against a background of climbing interest rates all within the framework of an international monetary crisis. I therefore feel it is imperative for all readers to understand both the technical situation on Wall Street and the monetary situation throughout the US and the world.

MONETARY: I am updating the monetary chart (see page 3) which appeared in the last mailing, and this should help readers to comprehend the money background. Note that the Utilities remain in their downtrend while the 40-Bond Average has taken a rather ominous dive over the past few weeks. (See last Letter, page 3).

"Will Go" has now provided us with more information. It is saying that the current rally should hold in force until about the end of August. Then there will be a few weeks of uncertainty, followed by an important decline in September. Will Go is based on a formula which utilizes the yield differential between the Dow and Barron's Hi-Grade Bonds (and so far, Will Go's "predictions" have been remarkably accurate).

Finally, the yield on Corporate Aaa bonds is 7.32 while the yield on T-Bills is 8.17, which gives us an inverse ratio of .90 this week. This is a new low for this valuable ratio, and readers probably remember that the Aaa/T-Bill yield ratio is saying "monetary problems" when it drops below 1.20. When it goes below 1.0 it is saying that the monetary problems have arrived. Thus this chart graphically calls our attentions to the underlying money mess which, as of this writing, casts a negative monetary cloud over the stock market.



THE US, 1973: Manipulate the money supply, control interest rates, "support" the dollar, bad-mouth the gold market, control exports, and now Phase 4 institutes what the rabidly pro-Administration San Diego Union terms "...the most complex and selective controls ever mandated by federal government in peace or war."

Even those who loath or have no faith in controls are taken back by the chorus of objections which have greeted Phase 4. To my mind, the bad part of the Phase 4 controls are (1) they are unworkable, but never have unworkable controls been so complicated, and (2) they represent a "new" phase, which means it will be many months before they can be politely jettisoned — so that "Phase 5" can be instituted.

Phase 4 was announced on July 18, but few observers that day noticed another phenomenon which I felt was equally important. On July 18, while all eyes were glued on Washington, the D-J 40-Bond Average (a broad average of four classifications of bonds) closed at 73.37, thereby breaking its 1973 and 1972 low and closing at its lowest level since late-1971. On the same day the D-J Utilities (another interest rate-sensitive indicator) closed within a point of its 1973 low.

Whenever the D-J Utility and 40-Bond Averages are in a joint downtrend, the background for the market must be considered negative. In view of this, it is worth noting that the Utility Average has declined during 6 of the last 8 weeks and the Utility Average has declined for the past 4 weeks in a row. It is also well to remember that the stock market can adjust to any given level of interest rates, but it cannot adjust to a continuing rise in interest rates.

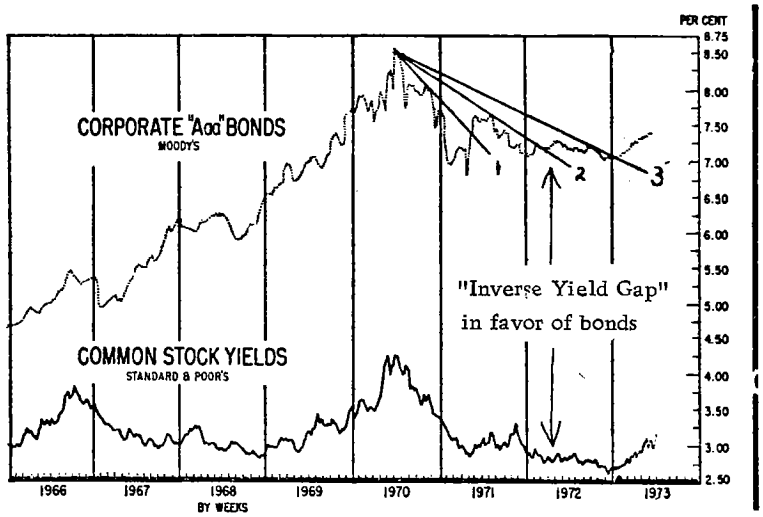
The prime rate has now moved to 8.5% in major banks across the nation, thus equalling the "worst" of the 1970 credit crunch. Certificates of Deposit ($100,000 or more) are now at 9.50% or better, actually above the 8.1% of 1970 (although there were restrictions on C/D's then). Commercial paper is now at 10.5% or better, which is above 1970. Treasury bills(91-days) hit 8.1% in 1970; they are currently 8.1% or in the identical area. And the bank discount rate, which was 6% at the worst of 1970, is now 7%, highest in 40 years.

In the last Letter I stated that we were in an interest-rate crunch, although few seemed to be aware of it. I believe the crunch is going to get worse, and I think the entire world is now moving into a period of super-high inflation, fake and temporary support for the dollar, vast confusion, and higher interest rates than anyone now thinks possible.

The average investor, growing bored and weary with high interest rates, may be tempted to pooh-pooh the lofty level of today's returns in the money market. But ponder this — money compounded at 6% doubles every 12 years — and money compounded at today's 9% levels doubles every 8 years! You say you can do better than double your money every 8 years by playing the stock market? Ask the pension fund managers about that one.

The chart on page 4 (courtesy of the Money Manager, 77 Water St., NYC 10005) shows the yield on the highest rated or Aaa-rated corporate bonds and the yield on the very broad Standard & Poor 500 Stock Average. Note that the peak in Aaa bond yields occurred at about 8.50% during the 1970 credit crunch. During 1971 Aaa yields dropped to 6.5%, a low they have not seen again. A second (higher) low was recorded very early in 1972 and a third (still higher) yield lows was seen in late-1972.

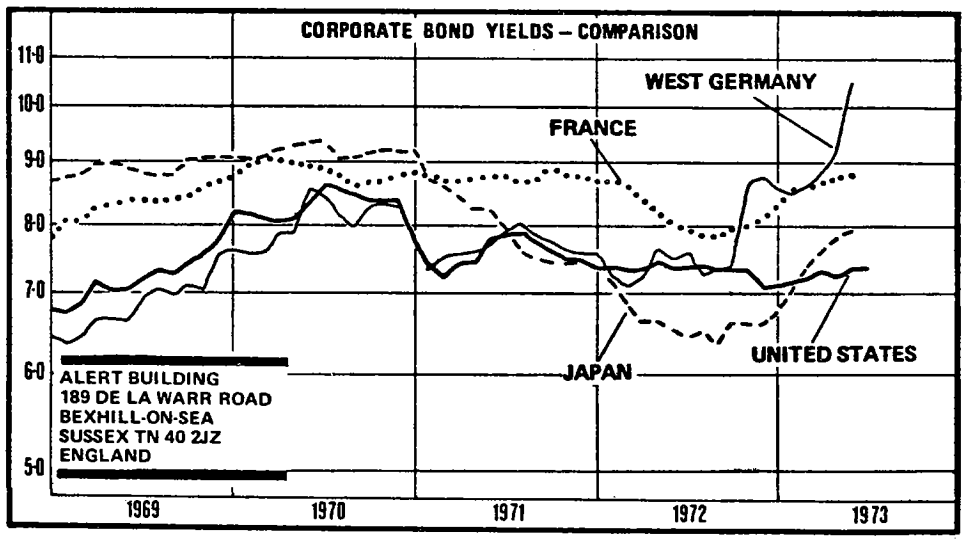
I have drawn three descending trend-lines from the 1970 peak, and here we see a beautiful example of the "fanline principle." As a rule, when a movement breaks down into three fan-trends as shown on the chart, that movement may be considered a correction of the main trend. When the third fanline is penetrated, the correction can be considered over, and the movement will then resume in the direction of the main trend — and the resumption is often rapid and in earnest.



In this case, the main direction of Aaa interest rates is obviously up, and the action since the 1970 peak can be considered a correction of the yield climb. This is a very serious picture, and it implies that Aaa interest rates will in time approach or possibly even pass their 1970 peak. Thus, it would not surprise me to see Aaa corporates move into the 7.5% range shortly and then towards and even above 8.0% as they test the 8.5% of 1970.

In the meantime, note that any rally in the stock market will serve to move common stock yields down, thus widening the explosive spread between the two yield indices. The spread is now about 4.25% in favor of Aaa bonds. This is the highest spread in 18 months, and I consider anything around 4.40 to 4.50% to be tantamount to a "stop sign" for the stock market. Therefore, either the bond-yield climb must halt or any stock market rally must be of very limited extent. At the moment, I do not see bonds doing anything in the face of the present credit crunch but declining (with accompanying rising yields).

I have written all along that I do not feel the US has been serious about halting inflation — I am still of that opinion. To stop inflation implies to face pain, and this no one has been ready to do. At this point in time, with the fires of inflation rising to inferno level, only the most drastic kind of recession would halt the march of prices. So far, at even the hint of recession, Washington pulls back as if it were staring into the mouth of hell. Yet, unbridled inflation will smash the economy far before a recession will. For painful as a recession is, it does produce adjustments, corrections and re-locations. Inflation brings no adjustments — only the systematic destruction of all savings and debt instruments (bonds).



As proof of the different attitudes of Europe and the US, I include this chart (courtesy of my British friends at Stock Market Alert). Here we see various corporate bond rates, and it is obvious that by American standards, US bond yields are now rather high. By European standards, US bond yields are at the low end of the scale. The world is now more closely connected or intertwined than ever before, and what Europe does affects us. I believe that over the coming months US bond interest rates will head upward toward the European levels — with corresponding pressures on the equity markets.

GOLD: I must be a fool, because I happen to subscribe to a thesis which Bernard Baruch underscored in his famous preface to the Mackay classic, "Extraordinary Popular Delusions and the Madness of Crowds" (if you haven't read it, it is a must.) "I have always thought," wrote Baruch, "that if, in the lamentable era of the 'New Economics,' culminating in 1929, even in the very presence of dizzily spiraling prices, we had all continuously repeated, 'two and two still makes four,' much of the evil might have been averted."

I thought of Baruch when I received my copy of the new publication by Yale Hirsch entitled "Smart Money." In the latest issue there appears a front page article entitled "Another devaluation coming? Gold $70/ounce?" The widely distributed service then goes on to say that authorities are seriously considering raising the official price of gold from the US's fixed $42.22 an ounce to $70. This would make everyone happy but South Africa and the speculators, says Smart Money, and it would mean that speculation in gold would be temporarily over.

Now I can tell one thing about this thesis. Who ever put it forth doesn't know markets. Whoever wrote it for Smart Money doesn't understand gold. For those gentlemen who are considering raising the "official price" of gold to $70 are not holding the power, they are simply trying to bluff their way into power.

Look at it this way. European central banks have large reserves of dollars, gold and various foreign currencies. The central banks have already taken horrendous beatings on the dollar portion of their reserves, and the only thing that has saved them from a collapse in reserves is the rising value of their gold holdings. Does anyone think that the US or anyone else is going to talk these European central bankers into fixing the price of gold at $70, thereby providing them with an instant massive beating on the gold portion of their reserves? Come on Smart Money, the US may be in dream world but Europe isn't.

I mention this because I have noted that the ADR's (American Depository Receipts) on the gold shares are prone to act like Mexican jumping beans, flipping and flopping with every outlandish rumor while the real international market in London is far more steady and is currently near its high for the year (Reuters Index). The fact is that Americans have never lived through a disastrous inflation, Americans still retain a mindless faith that "Washington will fix everything," and Americans somehow have been brainwashed into believing that Government, not supply and demand, exerts the ultimate power.

A second rumor is that Europe would "like to cut loose from the official $42.22 gold price" because then they could "sell gold on the open market." I know that Europe would like to cut loose from the $42.22 gold price, and I know that European central bankers state that then they could "trade gold." But what they would really like to do is to BUY gold on the open market, not sell it. Of course, they can't come out and say that so they state that they would like to be able to "buy and sell gold" or "trade gold." Again, I say let's use our heads. Why would the central banks want to sell gold— so they could collect more dollars?

Third rumor — "The US will sell $1 billion of gold and drive the price down." Dr. Harry Schultz answered this one in his latest report: "The days when $1 billion would affect gold are gone. One billion dollars can be swallowed up between breakfast and lunch any day in Zurich. Further, such action would send gold higher, the dollar lower (after two days of digestion) for the world would now know that there was that much less gold behind the dollar." (Thank you Harry)

As the dollar sinks into the sunset, new talk of props, swaps, supports and other such temporary manipulations and nonsense fill the air. But Europe is hardly falling for this emergency bunkum. For as the dollar falls, the dollar price of European (and Japanese) goods rises, and foreign imports get squeezed at Uncle Sam's borders. Thus the urging from foreign governments to support the dollar, to hold it up, to sell (US) gold to drive dollars higher, in short to "do something."

Some hint as to the bitterness comes from this cartoon caption from France's only mass-circulation daily. "Europe's cry of SOS in today's new monetary chaos begins and ends in a dollar sign, with nothing in between — $0."

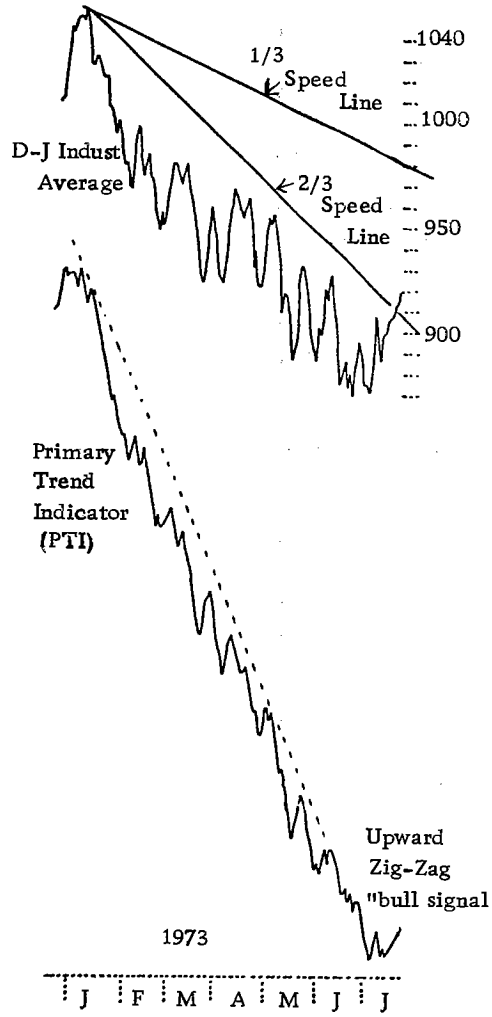
I thought the clip below, from Swiss Economic Viewpoint (published by the Foreign Commerce Bank, Zurich) put the whole international picture in sharp perspective.

Ultimately, there are two possible outcomes to the present monetary sickness that has already caused partial national and transnational economic paralysis: one, **now**, before world trade collapses, an immediate end to the trade war and the implementation of a major reform of the world's international monetary system (which must include a big hike in the U.S. official gold price and a return to dollar convertibility to take care of the more than one hundred billion dollar claims outside of the United States) and a return to balanced budgets and sound domestic monetary policies in the major countries[2].
The second possible outcome, rapidly becoming the most likely one, is that world trade will collapse, runaway inflation will destroy most currency values, we will go through a prolonged world depression from which a recovery will not begin until officialdom exhausts its myriad controls efforts, and—out of sheer desperation—finally resorts to freeing markets and returns to gold and silver money.

GOLD SHARES: I have been writing a good deal about the technical position of the gold shares. In Letter 568 I discussed the "speedline" principle in terms of ASA. Readers will probably be interested to know that none of the listed (NYSE) golds have broken their 2/3rds speedline on the current correction. This means that the leading listed golds retain their strongly bullish trend, even though a correction has been going on.

Up to a point, rulers thrive on crises. They need crises as an excuse to reinforce and expand their dominionship. During these periods they enlarge their bureaucracies and extend their control over private economic activity, not to be relinquished after a crisis subsides. If some nation-state officials have deliberately allowed the current international monetary situation to develop to its present chaotic state, they have made a gross miscalculation of both the risk that the U.S. dollar may become worthless and of the magnitude of the consequences this would have for the world economy.

In Letter 568 I also stated that short positions were building up against the primary bull trend in gold shares. Such a phenomenon means that an increasing number of people are willing to bet against a continuation of the bull market for gold shares. When the gold bull market is actually over, my feeling is that there won't be a gold bear around. The fact that speculators are putting their money down (in shorts) to bet against a further bull market in gold shares is, according to my studies, very long-term bullish for golds.



The latest figures for the gold shorts are interesting. The short interest in ASA jumped from 23,000 (June) to 57,000 in July. Homestake rose from 31,000 to 35,000. Giant Yellow Knife (Amex) rose from 1 thousand to 15,000. I do not yet have the July totals for Campbell or Dome, but assuming they stay the same as June, the total shorts in the five gold shares are as follows: March 61,000, April 63,000, May 47,000, June 78,000, July 130,000. In my experience, when a short interest builds up in a group or in the market and when that group or the market is in a long-term bull trend, the situation is moving towards a potential explosion.

Since these five gold stocks are fairly representative, I would say that the steadily rising short interest in these shares is typical of the prevailing psychology towards gold shares in general (whether Canadian, S. African or US shares). Thus, the technical underpinnings of the gold move becomes stronger and stronger, and for those who have not taken a position in golds I recommend a diversified portfolio (from 15% to 40% of your assets, depending on your disposition) in the following: Vaal Reefs, Kloof, President Brand, West Deiefontein, Blyvoors, President Stein, East Dreifontein, Elsburg (all ADR's), ASA, Campbell, Homestake (all on the NYSE).

LATE DEVELOPMENTS: The Primary Trend Index (PTI) on July 24 (as seen on the accompanying chart) reversed an extraordinarily long and severe downtrend line and bettered a preceding peak. This is the first time the PTI has given a bullish signal in 1973. I interpret this as the signal for a correction of the entire 1973 drop, and such a correction could mean an important rise in the great mass of the market. This implies a strong A-D ratio for the intermediate term and a forthcoming rise in many of the components which make up the PTI.

At the same time, the Dow (see same chart) has bettered its 2/3 speedline (see last Letter for explanation of speedlines), and this suggests a testing of the 1/3 speedline, which currently resides in the 970 area.

For those who wish to "play" this potential major correction, one of the best and easiest ways would be a no-load fund. What to do. Buy the no-load fund and hold it until we get our next set of sell signals, which could come later this summer (but I hate to guess, since it is always easier to identify a signal than it is to predict one).

Question: Isn't it risky speculating on this kind of a rally during a long-term bear market?
Answer: Of course it is, but the redeeming feature (if you're looking for one) is that you are speculating on a major correction in a depressed and badly battered market, following my first bullish signal this year. As Robert Rhea used to say, "Each man must kill his own snakes." I don't make the market, I don't run the market, I only study it, and I call it as I see it.

Question: Why do I say, "Buy a no-load fund instead of selected individual stocks?"
Answer: Because my data says that breadth (which was crushed in 1973) will correct on the upside, perhaps making up far more than the Dow on this move. A no-load fund provides a good way to "buy the breadth."

Question: If we get a major upside correction here, how will this affect the gold shares?
Answer: I feel that the gold shares are increasingly in their own market, rather than being merely reverse-shadows of the market. Golds are now moving into the high-earnings area, with many selling at 4 and 5 times prospective earnings. Thus for the first time, there is something under golds other than the knowledge of "what must come."

If I had to produce a timetable here, I would say that the general market will move up around the end of August (following Will Go's timetable), with golds consolidating. Then, the market could sell off and golds will make the next move up. In other words, this is accumulation time for the golds, trading time for market traders, and all in all one of the most dramatic markets in years.